Department of Financial Institutions   February 23, 2004

I) Program Names – **Banking**
Credit Unions

Department Mission Statement

The mission of the California Department of Financial Institutions is to ensure the integrity and stability of California's financial services system through the regulation and supervision of state licensed financial institutions.

A) The Department accomplishes its primary mission through the efficient and fair regulation of licensees, including the examination of state chartered banks as described in Financial Code Section 1900 (a) (3) et. Seq.

B) The expected outcome of this program is to ensure the integrity and stability of California State chartered Financial Institutions, thereby engendering public confidence and trust.

C) Other States.

State	Total Banking Department Budget 2002 ($000's)	# Field Bank Examiners
CA	$16,141	110
TX	$12,882	83
WA	$9,488	22
FL	$8,359	58
OR	$3,084	18
AZ	$2736 *	5
NM	$1,381	10

State	Total Credit Union Department Budget 2002 ($0	# Credit Union Examiners
AZ	$2736*	3
CA	$2,555	18
WA	$1,638	13
TX	$1,564	21
NM	$1,400	2
OR	$1,282	5
FL	Not available	24

* does not distinguish between Credit Union and Banking Budgets.

D) The Department's primary customers are its state chartered licensees. On a secondary level, the citizens of California benefit from a stable financial services system that provides a variety of financial services.

- The assessment of the Department's primary regulatory tool, the examination of Department licensees, is measured after each examination by a Department issued Quality Assurance Survey (QAS) which provides anonymity for the respondent, unless the licensee wishes to speak to the Commissioner concerning the recently completed examination.

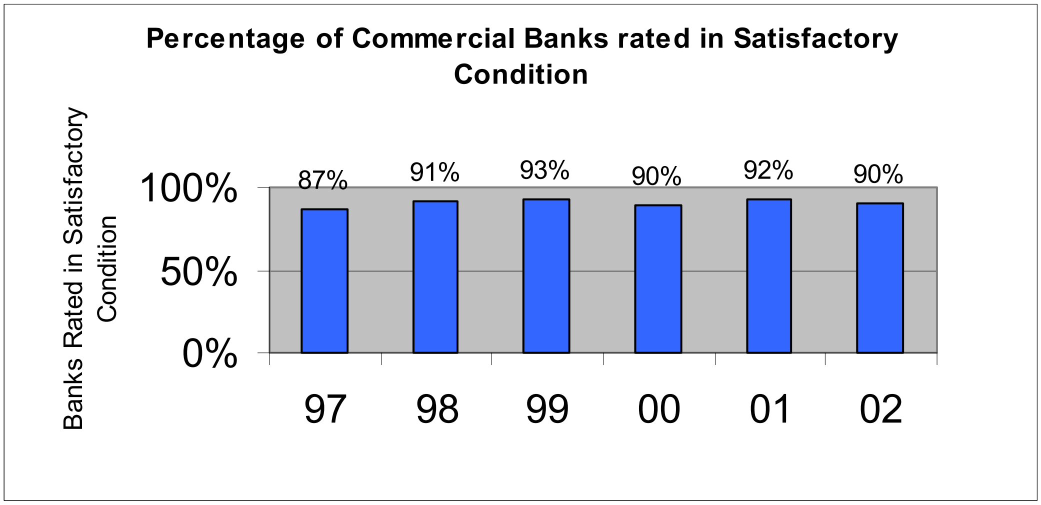
E) Obstacles to achieving the program's goals/expected outcomes include:

1. Changes to laws that are applicable to the Department or its licensees.

2. Changes in the State's hiring policies which may limit the staff to conduct examinations of Department licensees.

F) Not applicable.

G) 1) Metric – **Percentage of Commercial Banks rated in Satisfactory Condition**



1) The Department and all other state and federal regulatory entities of banking institutions utilize a standardized system of rating banking institutions.

The rating system provides for a composite rating based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components (known as a CAMELS rating) used to assess an institution's financial condition and operations are:

- Capital adequacy;
- Asset Quality;
- Management capability;
- Earnings;
- Liquidity, adequacy of; and
- Sensitivity to market risk.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and a least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and therefore, the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component rating assigned. However the composite rating is not derived by computing the arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

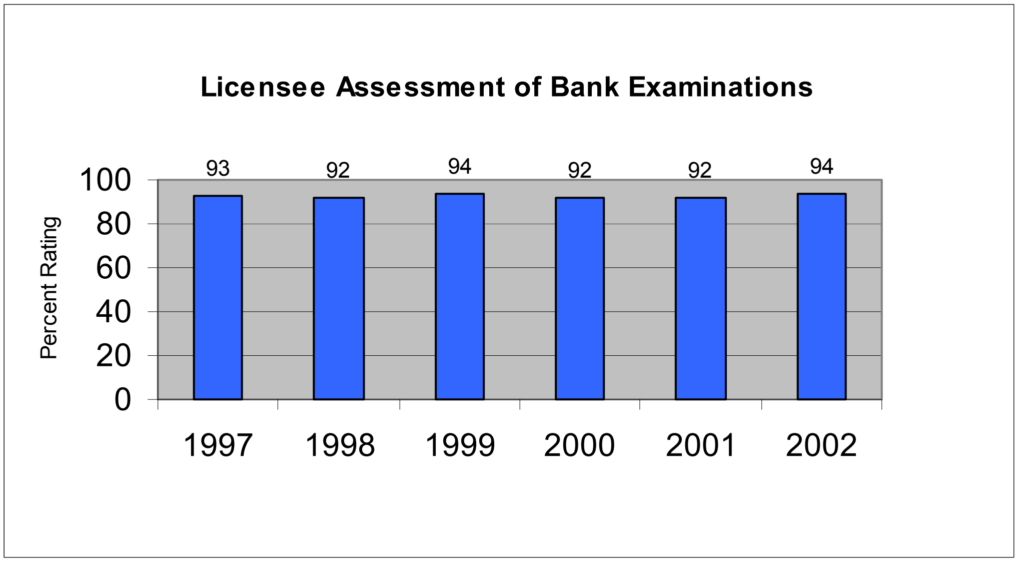
2. The Department accomplishes it mission by examining its licensees and using its supervisory authority to ensure that institutions address the risks noted during an examination. Thus institutions rated either a 1 or 2 are considered to have the least supervisory risk and are determined to be in satisfactory condition.

3. Banks that are in less than satisfactory or unsatisfactory condition are examined annually, rather than every two calendar years. The commissioner has deemed it advisable, to protect the integrity and stability of California's financial services industry, to examine these institutions every year, thereby increasing the Department's examination requirements and straining scarce resources.

4. The stability and integrity of California's financial services system is dependent on the sound operation of financial institutions. A perceived weakness by the public places a doubt on the safe and sound operation of the entire system. Thus to minimize the risk of a bank failure or a deterioration in the banking system, thereby creating doubt about the safe and sound operation by the public, it is incumbent to maintain banks in a satisfactory condition.

5. A deterioration in the U.S. economy, or a deterioration in a sector of the economy in which banks have loaned to, or invested in, may cause a significant deterioration in the number of banks in satisfactory condition. Regulators seek to minimize this risk by ensuring that financial institutions have diversified loan and securities portfolios.

G) 2) Metric – **Licensee Assessment of Bank Examinations**



1) The primary function of the Department is to conduct periodic examinations of our licensed financial institutions for the purpose of determining if they are operating in a safe and sound manner. It is through the examination process that we accomplish our mission and program outcome of ensuring the integrity and stability of California's financial services system.

After the completion of an examination the Department issues a Quality Assurance Survey (QAS) to the licensee examined. This is an anonymous survey which gives the licensee an opportunity to provide feedback to the Department regarding the usefulness of the information contained in the examination report, the conduct of the examination staff, and any other issues or concerns the licensee may have regarding the examination process.

The QAS measures numerous aspects of the quality of the examination including;

- The report of examination was received in a timely manner;
- The examination objectives and strategy were communicated clearly to appropriate bank management before the start of examination;
- The length of time used to conduct the examination was appropriate;
- The report of examination was consistent with the findings discussed at the exit review;
- Department personnel were available to quickly resolved examination questions and issues;
- Department personnel conducted themselves in a courteous and professional manner;
- Effectiveness of the examination criteria, including
  - Overall condition;
  - Capital adequacy;
  - Asset quality;
  - Management;
- Overall supervision.

2) Program managers utilize this metric to:

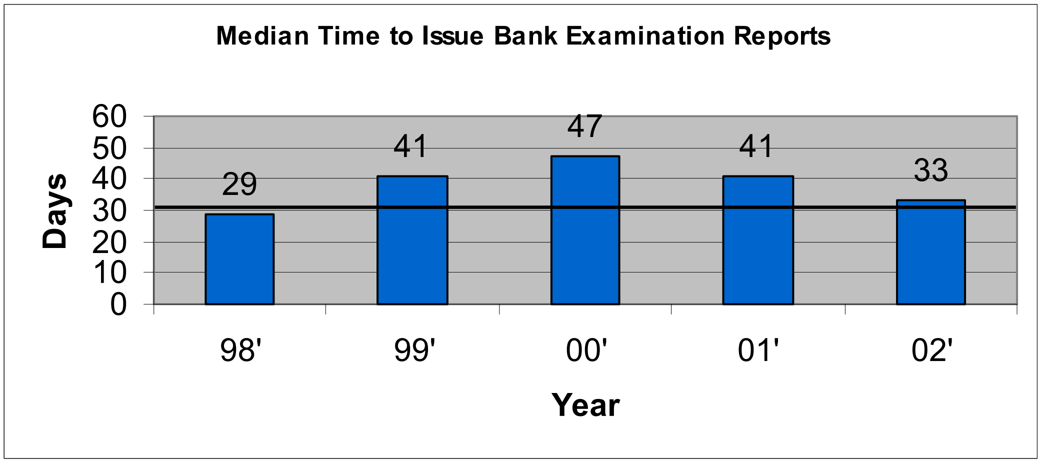
- To improve the quality of the examination reports;
- Improves the processing of examination reports;
- Measure the performance of their examination staff; and
- Determine staff training needs to improve examination performance and knowledge.

3) The examination report contains an evaluation of the institution and discusses those areas in need of attention. For institutions in need of substantive action, a regulatory order may be issued subsequent to the examination to make corrective actions and taken. If examinations are not conducted in a professional manner, or the quality of the report, on the findings do not mater, the findings as discussed at the examination exit meeting. Then the satisfactory rating of the examination conducted will be negatively affected.

4) The Department has achieved a high level of rating in this metric. A target was not established during the 2002-2003 period because of the large number of new examiners. Beginning in 2004, the Department will evaluate the metric to establish a target for 2004-2005. The numerous performance lower order metrics in the QAS enable the Department to determine the quality of staff, the examination process, and the examination report. Sharp declines alert Department management to problems in the process so that they can be quickly addressed.

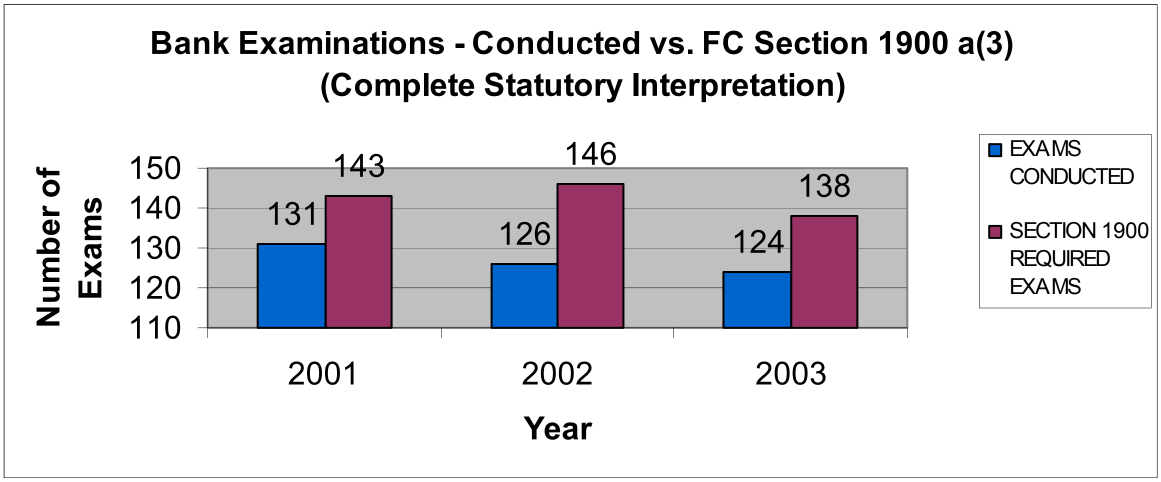
5) The QAS results can be affected by the experience of the examination staff. Examiners with less than three to five years experience will not be as accomplished in examination methodology and analysis, resulting in lower assessments of the quality of the examinations. The maintenance of an adequate number of qualified examiners is subject to State policies on the hiring of employees.

G)3) Metric - **Median Time to Complete Bank Examination Report**



1) This metric is linked to the program outcome because the examination report is the primary deliverable that contributes to the modification of a bank's condition.
2) The metric is used by the program managers to track the timeliness of the report to the licensee. The program managers work with examination staff to minimize delays in the completion of the report.
3) The greater the passage of time from the completion of the examination to the issuance of the report, the more "stale" the information and recommendations contained in the report become. For an unsatisfactory licensee, the stale information may exacerbate the time required to improve the unsatisfactory condition(s) noted in the examination. An increase in the number of unsatisfactorily rated institutions is contrary to the outcome measure G1, Percent Commercial Banks Rated in Satisfactory Condition.
4) The target by internal policy is 30 days after the completion of the examination.
5) 1999, 2000 and 2001, the median time to complete the report increased. The Department believes this was due to heavy workload as the results of a high number of vacancies in 1999 followed by a large number of new examiners hired in 2000. It takes 3 to 5 years to train an examiner to the journey level. During that period the number of errors in the preparation of the report and the quality of the content of the report must be carefully monitored by the Examination leader and the program managers. While the examiners hired in 2000 have greatly increased in skill and the metric is moving toward the target, the budget reduction in staffing and the delay in hiring to due the hiring freeze may create an increase in the median time for report completion in the 2003 and 2004 report periods.

G) 4) Metric - **Bank Examinations – Conducted vs. Financial Code Section 1900(a)(3)**

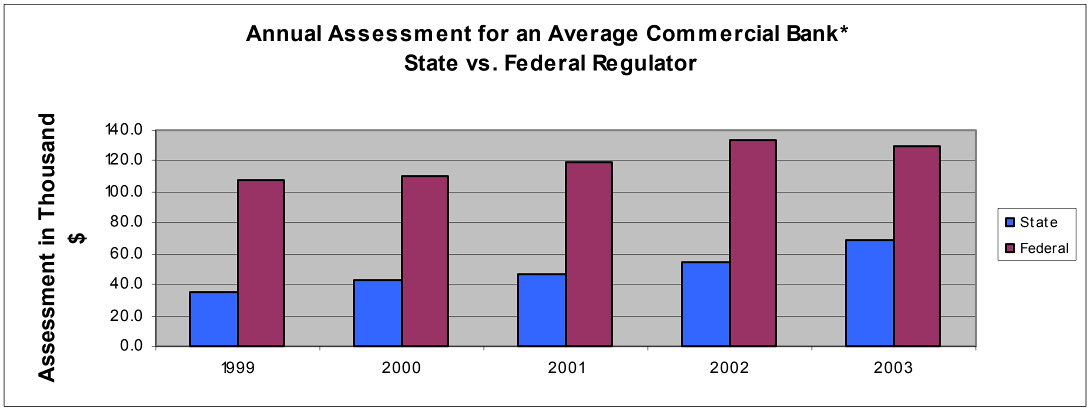


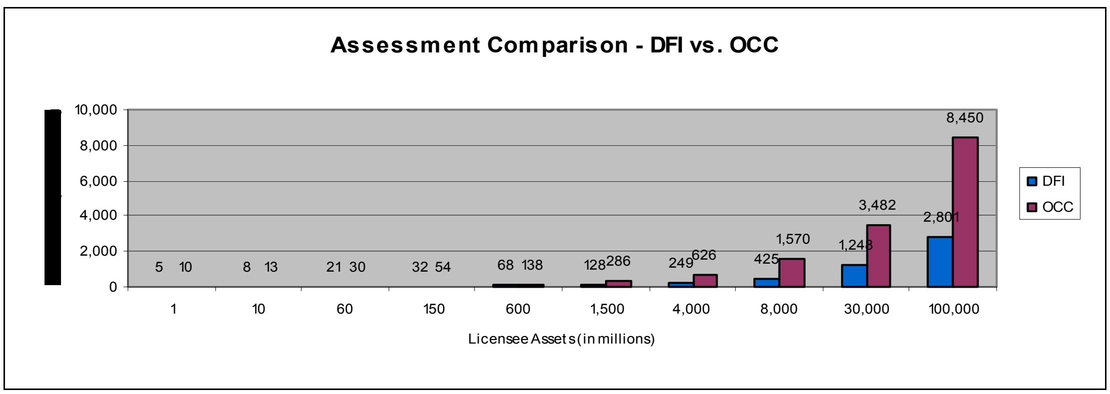
1) The primary methodology for measuring the integrity and stability of California's financial institutions is the financial institution rating by the Department that is derived from an examination of that institution. While the Department has met the requirement that every bank, trust company, and every foreign bank be examined not less than once every two calendar years, it has not met the commissioner's mandate to examine all banks with one billion dollars or more in assets, all banks identified as "less than satisfactory" and each new bank (within the first two years of opening) on an annual basis.
2) The Financial Institutions Supervisors (those who schedule examinations) use the metric to determine the examinations that need to be conducted during the coming calendar year, based upon the two requirements of Financial Code Section 1900 (a)(3). Once the examinations needed to comply with the law are determined, the Financial Institution Supervisors calculate the number of examiner hours available for the coming year and attempt to adjust the scope of the examinations to ensure that all required examinations are conducted.
3) The Financial Institution Supervisors and senior examination staff feel that adjusting the scope of the examinations in recent years to meet the examination timetable objectives provide for examinations that may have lacked the depth of analysis necessary to determine all of the risks in a given financial institution. Because something may be missed, a small problem could become much larger between examinations. Thus while the examination objectives may be met with regard to the number of examinations conducted, the scope may become compromised to the extent that problems in a financial institution may be missed.
4) The examination target is supported by Federal Reserve Board Economic Letter 99-07 of February 26, 1999, which looked at the "time decay" of supervisory information, that is, how the length of time between examinations affects the

quality of supervisory information: “Quality” here reflects how accurately supervisory information from a previous examination reflects the bank’s current condition. The study concludes that banks with CAMELS ratings of 1 or 2 are of some use for 6 to 12 quarters, while those banks with low supervisory ratings of 3-4-5 are of some use for only about 3 to 6 quarters. The findings suggest that the rates of decay in supervisory information are considerably faster for banks experiencing some degree of financial difficulty, and support the need to examine such institutions annually.

5) The metric results can vary, based upon:
   - The number of examinations that need to be conducted in any given year based upon the requirements of Financial Code Section 1900(a)(3);
   - The number of new institutions chartered that need to be examined;
   - The asset growth of the banks that need to be examined;
   - The deterioration in the CAMELS ratings of institutions and the need to examine them annually;
   - A decline in institutions due to sale or merger with a national charter bank;
   - The number of examiners and examiner hours available to conduct examinations; and
   - Changes in the scope of examinations conducted.

G) 5) Metric – **Annual Assessment for an Average Commercial Bank**





Assessment Comparison--California Department of Financial Institutions vs. Office of the Comptroller of the Currency			
	DFI	OCC	DFI Assessment as a percent of OCC rate
ASSETS	Assessment	Basic Annual Rate	Basic Annual Rate
1,000,000	5,000	10,000	50%
10,000,000	8,100	13,320	61%
60,000,000	21,330	30,749	69%
150,000,000	32,029	54,817	58%
600,000,000	68,648	138,641	50%
1,500,000,000	128,048	286,372	45%
4,000,000,000	249,548	626,656	40%
8,000,000,000	425,048	1,570,196	27%
30,000,000,000	1,248,548	3,482,192	36%
100,000,000,000	2,801,048	8,450,852	33%
Note: Comparison of 2003 DFI base assessment rate of 1.35 and two semi-annual 2003 OCC assessments			

The United States has the strongest and most innovative banking system in the world, in large part because banks have the choice of being regulated by the state or federal government. Dual chartering of banks has over a 130-year history in our nation. It was in 1863, after 80 years of solely state regulation, that the federal government began chartering and regulating banks.

This choice of charters creates:

- A healthy dynamic tension among regulators;
- Innovation in financial products;
- A wider range of products and services available to consumers;
- Lower regulatory costs; and
- Provides for more effective and responsive supervision.

The choice of charters prevents a concentration of power in one regulator, which can result in:

- Higher costs to the regulated entities;
- Unresponsiveness on the part of the single regulator; and
- No incentive for creativity.

The state banking system has produced the following innovations:

- Checking accounts;
- Real estate lending;
- Trust services;
- Deposit insurance;
- ATM machines;
- NOW accounts; and
- Branch banking.

Bankers like being a state bank because they:

- Have access to the Commissioner;
- Like Department knowledge of the local markets;
- Like quick turnaround time on their questions; and
- Like the lower annual cost of the state charter.

1) The annual assessment, or the cost of doing business with a banking regulator, as noted above, is a major factor when considering what type of charter to pursue when applying to establish a bank. The metric shows that the Department is less costly, by a significant degree, in accomplishing the regulatory mission of ensuring the stability and integrity of its licensees.

2) Program managers use this metric to illustrate to potential new bank applicants one of the numerous advantages of becoming a State chartered financial institution.

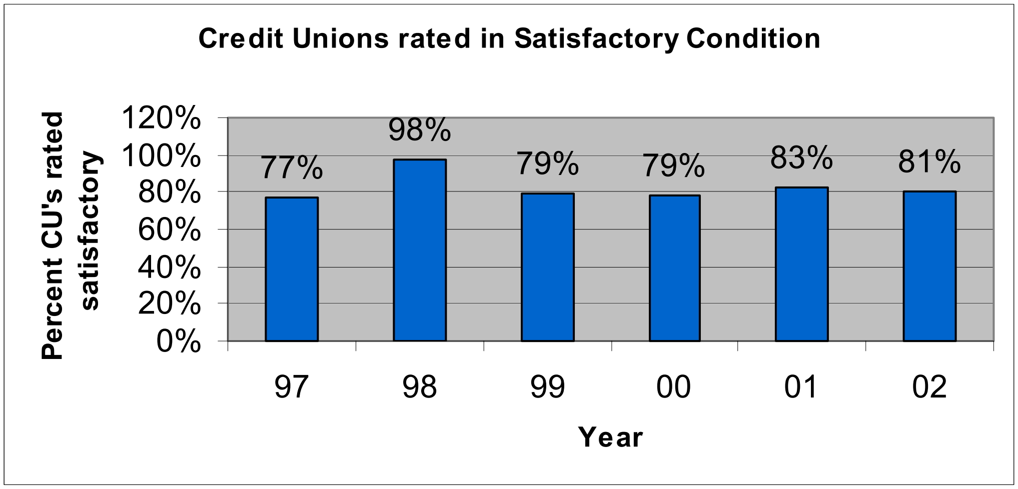
3) Increases and decreases in the assessment can affect the attractiveness of the State charter to potential licensees.

4) The target for this metric is to maintain as much difference between the cost of State charter and Federal Charter. The assessment rate is calculated on an annual basis by determining the Departments' authorized expenditures and allowing for uncertainties with a reasonable reserve. The assessment is then calculated by applying the formula found in Financial Code Section 270 et seq.

5) This target may fluctuate due to:

- Increases/decreases to the Department budget;
- A major state chartered financial institution being acquired by a federally chartered bank;
- A switch to a national bank charter to take advantage of preemption of state law interpreted by the Office of the Comptroller of the Currency ("OCC"); or
- Borrowing of State Banking Fund monies.

G) 6) Metric – **Percentage of Credit Unions rated in Satisfactory Condition**



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5) A deterioration in the U.S. economy, or a deterioration in a sector of the economy in which credit unions have loaned to, or invested in, may cause a significant deterioration in the number of credit unions in satisfactory condition. Regulators seek to minimize this risk by ensuring that financial institutions have diversified loan and security portfolios.

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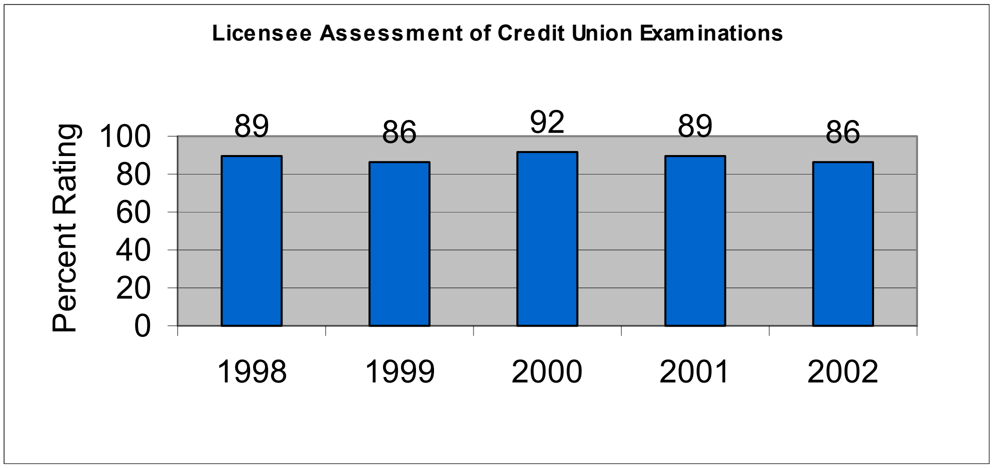

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- Measure the performance of their examination staff; and
- Determine staff training needs to improve examination performance and knowledge.

3) The examination report contains the evaluation and recommendations for the licensee to maintain its satisfactory rating or if applicable the areas to address to correct an unsatisfactory rating. If examiners do not conduct a quality exam and provide a quality report, then the overall percent satisfactory condition measure may be negatively affected.

4) The Department has achieved a high level of rating in this metric. A target was not established during the 2002-2003 period because of the large number of new examiners. Beginning in 2004, the Department will evaluate the metric to establish a target for 2004-2005. The numerous performance lower order metrics in the QAS enable the Department to determine the quality of staff, the examination process, and the examination report. Sharp declines alert Department management to problems in the process so that they can be quickly addressed.

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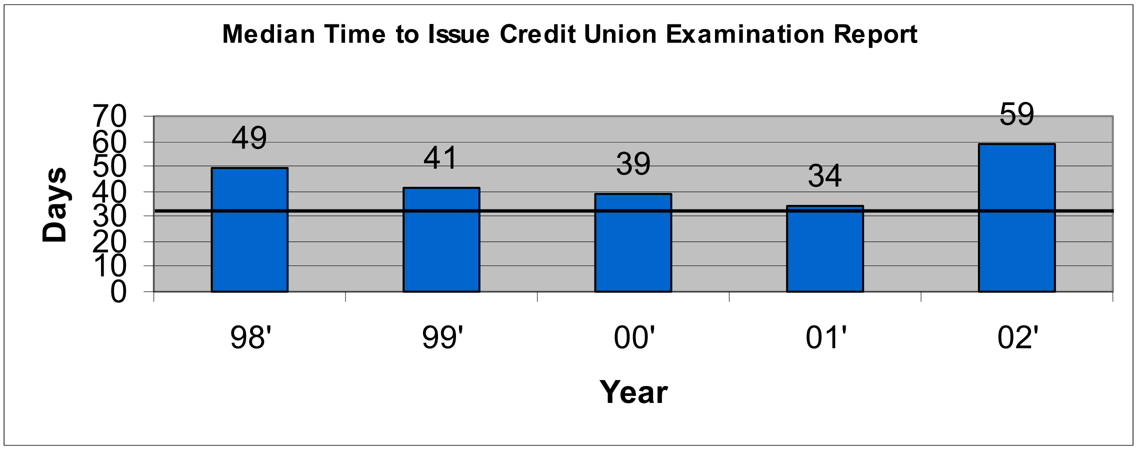

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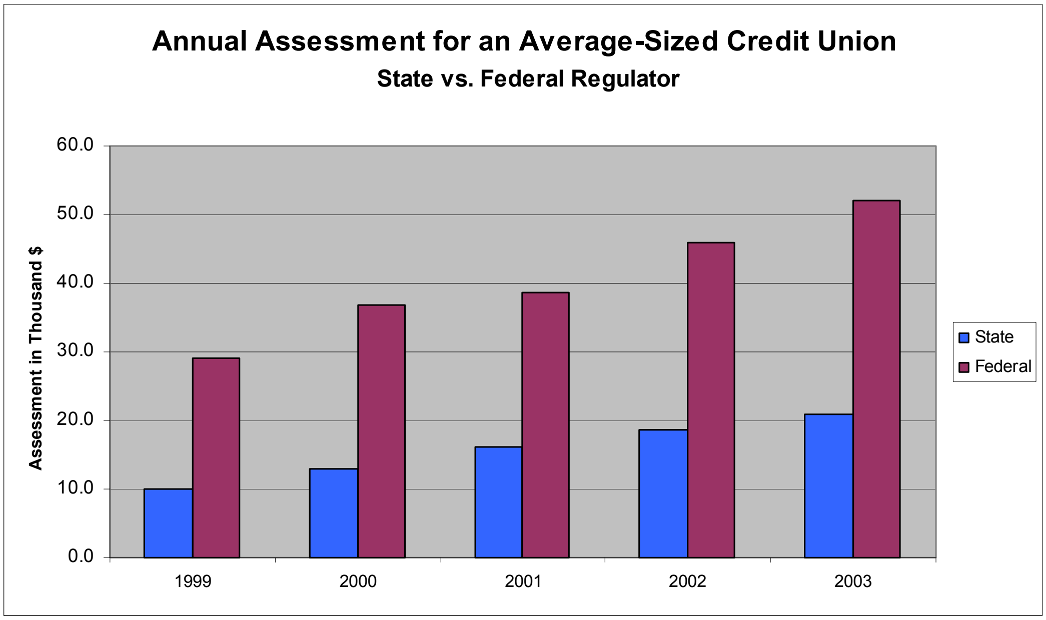
4) The target by internal policy is 30 days after the completion of the examination.
5) In 2001, the median time to complete the report increased. The Department believes this was due to the increase in the number of new credit unions chartered (four), and a 16 percent increase in the assets of credit unions under supervision. This represented a tremendous increase in workload (number and complexity) with a corresponding increase in the report time. A budget change proposal in 2002 added four new examiners. It is expected that the report time metric will move in a positive direction. It takes 3 to 5 years to train an examiner to the journey level. During that period the number of errors in the preparation of the report and the quality of the content of the report must be carefully monitored by the Examination leader and the program managers.

G) 9) Metric – **Annual Assessment for Credit Unions**



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- Borrowing of State Credit Union Fund monies.